RECEIVED

OCT 26 1998

FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF THE SECRETARY

Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

In the Matter of	)	
	)	
Access Charge Reform	)	CC Docket No. 96-262
	)	
Price Cap Performance Review for Local Exchange Carriers	)	CC Docket No. 94-1
	)	
Emergency Petition for Prescription of MCI Telecommunications Corporation	)	CC Docket No. 97-250
	)	
Petition for Rulemaking of the Consumer Federation of America, International Communications Association and National Retail Federation	)	RM-9210

COMMENTS OF THE COMPETITION POLICY INSTITUTE

IN RESPONSE TO PUBLIC NOTICE FCC 98-256

October 26, 1998

COMMENTS OF THE COMPETITION POLICY INSTITUTE

A. Introduction and Summary

The Competition Policy Institute (CPI) is a non-profit organization that advocates state and federal policies to bring competition to telecommunications and energy markets in ways that benefit consumers. In these Comments, CPI responds to the Commission's invitation to update and refresh the record in these associated cases concerning access charge levels, the functioning of the FCC's price cap mechanism and the Petition for Rulemaking filed by the Consumer Federation of America, International Communications Association and National Retail Federation. In these Comments, we present data showing that the growth in UNE-based competition for exchange access services, while steady, is sufficiently slow that the Commission must act to order additional prescriptive reductions in interstate access charges. We support modifying the price cap formula in several justifiable ways to achieve these prescriptive reductions. We also conclude that the Commission need not, and should not, grant substantial pricing flexibility to incumbent local exchange carriers in the provision of switched access services until there is substantially more competition in these markets.

In our original Comments[1] in response to the Commission's Notice of Proposed Rulemaking in these matters, CPI endorsed the general approach to access charge reductions that was eventually adopted by the Commission: an initial prescriptive reduction followed by reliance

---

[1]Comments of the Competition Policy Institute, January 29, 1997, In the Matter of Access Charge Reform, Price Cap Performance Review for Local Exchange Carriers, Transport Rate Structure and Pricing, Usage of the Public Switched Network by Information Service and Internet Providers. CC Dockets Nos. 96-262, 94-1, 91-213 and 96-263.

on increasing market forces, backed up with the regulatory promise of additional prescriptive reductions if market forces proved to be insufficient to reduce access charges on a timely basis. While we disagreed with the level of initial access charge reduction ordered by the Commission,[2] we thought the Commission basically adopted the right approach. We also supported the concept of periodically revisiting access rates to determine whether competition was pushing prices down or whether additional prescriptive reductions were needed.

We have not abandoned our support for that basic approach. However, it is now clear that consumers are not being served by market forces sufficient to bring down access charges—at least not for the foreseeable future. CPI agrees with the Petitioners CFA, ICA and NRF that the changed circumstances since the *First Report and Order*[3] require the Commission to review its choice to rely fundamentally on market forces to reduce access charges, at least in the near term.

Specifically, the adverse rulings of the 8th Circuit Court of Appeals are retarding the entry of new local exchange competitors using unbundled network elements (UNEs). This means that the Commission cannot confidently rely on its assumption that UNEs will provide the engine for the growth of competition in exchange access services. Further, facilities-based competition for access services from competitive access providers (CAPs) is still insufficient to provide any real pressure for lower access rates at the present time. Mergers and consolidations among CLECs,

---

[2]CPI advocated that the Commission reduce interstate access rates by $2 billion beyond the reductions that would have occurred under price cap regulation. In its *Price Cap Fourth Report and Order*, the Commission ordered reductions of approximately $1.7 billion, of which about $700 million were scheduled annual rate cap reductions.

[3]*First Report and Order*, In the Matter of Access Charge Reform, Price Cap Performance Review for Local Exchange Carriers, Transport Rate Structure and Pricing, End User Common Line Charges. CC Dockets Nos. 96-262, 94-1, 91-213 and 95-72.

IXCs and CAPs raises the question whether growth in facilities-based competition in the access market will provide any real pressure on access rates within a reasonable time frame.

Here is the bottom line: perhaps sooner than anticipated, the Commission must now review the assumptions that underlie its trust in market forces to bring down the level of access charges and adopt additional prescriptive reductions. *The Commission need not abandon its long term commitment to using market forces to reduce access charges; but it must recognize that the prospects of market forces offering relief in the short term are now remote.* In these Comments, we offer several specific actions the Commission should undertake as part of this task.

B. In View of Changed Circumstances Since Adoption of the First Report and Order, the Commission Should Prescribe Additional Access Reductions

There is near uniform agreement that interstate access services are priced well in excess of their forward looking economic costs. This pricing distortion affects all levels of the market: end user consumers pay prices that are too high with the result that use of long distance service is artificially suppressed; interexchange carriers pay prices for access services that are artificially high and are induced to build or order access arrangements that are economically inefficient; finally, when the Bell Operating Companies enter the long distance markets, competition among providers of bundled telecommunications services will be distorted when one of the competitors, an incumbent LEC, is also provides access services to other competitors at rates that are substantially above prices that a competitive access market would produce. For these reasons, the merits of lower access charges need little elaboration here. The Commission recognized the central role that exchange access prices play in the new competitive scheme designed by

Congress: "to fulfill Congress's pro-competitive mandate, access charges should ultimately reflect rates that would exist in a competitive market."[4] Perhaps the only contentious question left is how quickly, and by what mechanism, access charges should be reduced to competitive levels.

As for the mechanism, the Commission concluded in its *First Report and Order* that "we strongly prefer to rely on the competitive pressures unleashed by the 1996 Act to make the necessary reductions."[5] As for the timing, the Commission acknowledged that "a market-based approach under this scenario may take several years to drive costs to competitive levels."[6] Finally, the Commission recognized that competition may not develop quickly for some access services and included a remedy in that circumstance: "In addition, we also adopt a prescriptive "backstop" to our market-based approach that will serve to ensure that all interstate access customers receive the benefits of more efficient prices, even in those places and for those services where competition does not develop quickly.[7]

It is important to note that the "market-based" pressure on which the Commission relies to provide price competition for access services actually requires the intervention of regulators (and lawmakers), viz., implementation of Section 251 of the Communications Act. In its *Local*

---

[4]*First Report and Order*, ¶42.

[5]Id., ¶46.

[6]Id., ¶45.

[7]Id., ¶267.

Competition Order[8], the Commission correctly reasoned that new local exchange competitors should be able to acquire and assemble UNEs to provide both local exchange service and exchange access service without paying additional inflated access charges on top of the price paid for the UNEs. And if UNEs were priced at forward looking economic costs, it would follow that, incrementally, pressure would build on the access prices of ILECs as the new entrants began to win local customers.

But this scheme obviously depends fundamentally on three premises: 1) that UNEs are priced at forward looking economic costs; 2) that UNEs are readily available to new entrants at these prices; and 3) that new entrants are able to enter the local exchange market service and serve customers using UNEs. Unfortunately for consumers, the practice has not yet matched the theory. Several events have conspired to reduce or eliminate the assumed pressure that UNEs would exert on access prices and none of these three necessary conditions has been met.

First, and most importantly, action by the Eighth Circuit Court of Appeals has invalidated the Commission's pricing rules for interconnection, including UNEs. The authority to set rates for UNEs has now passed to the state commissions. While many states have tended to follow the lead of the FCC by pricing UNEs to reflect economic costs, not all states have done so. In fact, some states cannot do so by state law.[9] Many states have not yet adopted final prices that

[8]Implementation of the Local Competition Provisions of the Telecommunications Act of 1996, CC Docket No. 96-98, First Report and Order (rel. August 8, 1996) *aff'd in part and vacated in part*, Iowa Util. Bd., 120 F.3d 753.

[9] The Arkansas General Assembly passed legislation in 1997 that requires the price of unbundled network elements to reflect the "actual cost" incurred by the incumbent local exchange carrier. "Actual cost" is widely interpreted to refer to embedded costs and cannot be interpreted to mean to forward looking economic costs.

comport with forward looking economic costs; in many cases even the interim decisions of state commissions are on appeal in state and federal courts. Simply put, there is no assurance that states will be able to follow through on the first assumption underlying the Commission's market-based approach. Without an assurance that states will (or even can) set UNE prices at economic levels, the Commission cannot reasonably base its plan for access charge reductions on the assumption that such forces will develop "quickly."

In the last year it has become clear that the second assumption—that UNEs are readily available to new entrants—also fails to hold. Through its §271 proceedings, the Commission has become well acquainted with the shortcomings of some ILECs' provision of operating support systems (OSS). The failure of the incumbents to develop adequate OSS systems has sharply limited the ability of CLECs to enter the local market in a substantial way. The competitive forces "unleashed" by the 1996 have proven to be tame indeed, largely because of the failure of the industry to develop a system of back office processes capable of processing the orders that customers will place. As we pointed out in our Comments in the original NPRM, the task facing new entrants is enormous: to win the business of just 30% of the lines served by today's incumbent local exchange carriers, CLECs will need to win **42,000 new customer lines every business day for the next five years.** Given the churn of switching customers and the multiple queries required to switch and set up service for a new customer, OSS systems will have to be able to handle many times this number of transactions. It is manifestly evident that they cannot meet that challenge today. Without these systems, the Commission cannot assume that market-disciplining UNE-based competition will be a reality any time soon.

The third condition, that competitors can actually enter the market using UNEs, is also called into question by a decision of the 8th Circuit Court of Appeals: its November 1997 decision on reconsideration. By determining that the ILECs could unbundle previously bundled network elements, the Court severely limited the practical usefulness of UNEs as an entry strategy. This ruling effectively eliminated the "UNE platform" which had been identified by many CLECs as a feasible means to enter the local exchange market in a mass market fashion. Instead of negotiating the price of the UNE platform, new entrants and state commissions find themselves grappling with the new issue of special charges and procedures for "gluing" UNEs together.

The collective effect of these assaults on the provision and use of UNEs is to reduce the rate at which new entrants have been able to enter the local exchange market. This fact has been noted by Wall Street. Merrill Lynch estimates the gross local market share gains (in revenues) of CLECs will be about 5.4% of the entire local market by year end 1998 and only about 7.7% by the end of 1999. The net revenue losses to the ILECs are even smaller because of the wholesale payments by CLECs to ILECs.[10]

In terms of access lines, Merrill Lynch estimates that CLECs (including the IXCs) will

---

[10]On January 5, 1998, Merrill Lynch analysts observed: "Like 1997, we anticipate <u>RBOC share losses will be less than originally expected over the new few years</u>. We estimate that cumulative '97 *gross* local revenue share losses totaled 2.6% and will grow to 7.7% by year end '99. However, after accounting for wholesale revenue recovery (via resale and unbundling), we estimate *net* local share losses will total 1.1% in '97, increasing to only 2.7% by the end of '99. On an incremental basis, we estimate *net* local revenue share losses will total 0.5% in '97, increasing to only 0.8% in '98 and '99." (underlining added; italics in original.) "United States Telecommunications/Services; Telecom Services -- Local: 4Q Preview: Solid Year-End with 10% Average EPS Growth" Merrill Lynch: January 5, 1998.

serve about 2.9% of the nation's access lines by year-end 1998. It is estimated that only 28% of this number will be served through UNEs; the remainder is split evenly between total service resale and separate facilities, with each entry mode make up about 36% of the access lines served by competitors.[11] This means that, ***by the end of 1998, competitors to the ILECs will serve only about 1.4 million (0.8%) of the nation's estimated 177 million access lines through UNE-based entry***.[12]

While the sequential (quarter-to-quarter) growth in CLEC access lines is steady, it is slow. In fact, the number of access lines won by CLECs is actually smaller than the growth in access lines for the local service sector. This might indicate how much CLECs can grow, but it also indicts the theory that UNE-based entry will place significant pressure on access charges any time soon. The relatively tiny number of lines served by UNE-based entry cannot reasonably be assumed by the Commission to put any pressure on access charges.[13]

C. The Commission Should Use the Price Cap Mechanism to Make An Additional Prescriptive Reduction in Access Charges.

The Commission put carriers on notice of its intention to exercise its "backstop" authority in the event that market pressures did not reduce access charges. It is now time for the Commission to follow through on that promise. The record in the *Price Cap Performance*

---

[11]"United States Telecommunications/Services; Telecom Services -- Local." Merrill Lynch: September 22, 1998, pp. 21 and 28. Excerpts from this report are attached to these Comments.

[12]Id.

[13]Of course, facilities-based access competition provides pressure on ILEC access rates. But the cost of recreating the ILECs' network is very high and the Commission was correct to identify broad-based competitive entry through UNEs as a significant source of pressure on access rates.

Review supports substantial additional reductions in access charges. By basing the X-factor on interstate services productivity measures, by eliminating (or adjusting downward) the rate-of-return floor, among other adjustments, and by making such changes effective with the 1995 access tariff filings, the Commission can solidly justify a multi-billion dollar reduction in access charges.

CPI previously recommended that the Commission reduce carrier access charges by about $2 billion in July 1997. We characterized that recommendation as a "down payment" on access reductions. The actual reductions ordered by the Commission (after accounting for the scheduled price cap reductions) were only about $1 billion. Since July 1997 there has been such insufficient development of competition in exchange access service that the Commission should now make additional "prescriptive" reductions in access charges. We recommend that the Commission take this opportunity to reduce annual access revenues of the price cap carriers by at least $2 billion at the time of the 1999 tariff filing. This reduction should be in addition to the July 1997 reduction and should be in addition to any scheduled reductions due to the action of the price cap formula. This is entirely reasonable in view of the downward trajectory access charges must take if they are to meet the Commission's goal of approaching the level that a competitive market would produce.

D. The Commission Should Not Grant Pricing Flexibility to the ILECs Until There is Substantially More Competition for Exchange Access Services.

Until there is substantially more competition in exchange access services, the Commission should not grant flexibility to the ILECs in pricing those services. The slow growth of CAPs and the slow growth of incremental pressure from facilities-based and UNE-based local service competition is insufficient to control the market power enjoyed by the incumbents. CPI certainly agrees that pricing flexibility is appropriate when meaningful competition arrives. Unfortunately for consumers, that time has not arrived for access services.

In its June 5, 1998 *ex parte* filing, Ameritech describes a proposal to create "pricing flexibility" by eliminating the price cap X-factor and by permitting geographically deaveraged prices for switched access and transport services.[14] Ameritech suggests triggers for its various proposals that are tied to the percentage of a market "addressable" by competitive providers.

CPI concurs with the general concept that the degree of pricing flexibility should be tied to the level of competition faced by an incumbent LEC. However, we have severe reservations about portions of the Ameritech proposal. First, it is inappropriate to link pricing flexibility to the *theoretic* potential of competition. CPI recommends that the Commission consider whether an incumbent faces actual competition for services, not merely whether other companies can theoretically "address" the market. Second, geographic deaveraging should permit an incumbent provider to respond to competition by lowering prices; it should not be a mechanism to allow the carrier simultaneously to increase prices in non-competitive geographic regions. In other words, pricing flexibility should initially be *downward* only. Third, the Commission should reject the broad assertion that the X-factor impedes investment activity of the ILECs. Ameritech's advocacy for removing the X-factor should be seen for what it is: an attempt to increase earnings before actual competition emerges to drive access prices down to competitive levels. The effect

[14] *Ex Parte* Filing of Ameritech in CC Docket 96-262, filed June 5, 1998.

of the X-factor may well be superceded someday by pressure from competitors. Until competition is vibrant, it would be inappropriate, counter-productive, and harmful to consumers to reduce or eliminate the X-factor in the Commission's price cap formula. Indeed, as we noted above, the Commission should now increase the X-factor to prescribe lower access rates.

E. Conclusion

Competition in the local exchange market will translate into lower exchange access charges and lower long distance rates. Consumers expect and deserve this outcome. The Commission's decision to rely on market forces to drive down access charges was a reasonable decision at the time, considering the assumptions. Unfortunately for consumers, those assumptions may no longer be valid. The Commission should acknowledge this reality and make additional prescriptive reductions of at least $2 billion in interstate access charges.

Respectfully Submitted,

Ron Binz

Ronald J. Binz, President
Debra R. Berlyn, Executive Director
John Windhausen, Jr., General Counsel

Competition Policy Institute
1156 15th Street, N.W., Suite 520
Washington, D.C. 20005
(202) 835-0202
Fax (202) 835-1132

October 26, 1998

Merrill Lynch

In-depth Report

United States
Telecommunications/Services

22 September 1998

Dan Reingold, CFA
(1) 212 449-5631
Mark Kastan, CFA
(1) 212 449-3241
Shannon S. Cross
(1) 212 449-4341

Telecom Services — Local

CLEC Update: Continued Weakness In The Sector Creates A Great Buying Opportunity

Reason for Report: 2Q98 Review

Industry

Investment Highlights:

- CLECs reported revs. in line with our ests. with strong data & dedicated rev. growth, offsetting lower than est. local & LD switched revs.
- At June 30, new entrants' (CLECs and the local efforts of LD cos.) rev. share of the US local telecom mkt. stood at 4.1%, up from 3.5% on March 31. We est. that by year-end 1998, the CLEC's share of the $105B local telecom mkt. will reach 5.4% or approx. $5.7B. Given our est. that the local mkt. is adding $4-5B in new revs. annually, CLECs should be able to maintain their rapid growth while mainly just feeding off the growth in the mkt.
- During 2Q we est. the CLEC group (incl. local efforts of LD cos.) captured 0.53% of the $102B local market, equiv. to a 2.1% annual share gain, up 20 basis points over 1Q's annlz'd share gain of 1.9%. We expect the group's share gain to increase to an annlz'd 2.5% of the $105B local market by 4Q98.
- In line with our ests., during 2Q CLECs (including local efforts of LD cos.) added an est. 637,559 net local access lines, 12% above 1Q's est. 571,675 access line additions. According to our ests., average CLEC line mix for 2Q was 36% on-net, 28% unbundled network elements (UNE), and 36% total service resale (TSR) — virtually unchanged from 1Q.
- During 2Q, Intermedia reported positive EBITDA, becoming the only publicly traded CLEC with positive EBITDA, as Teleport is no longer publicly traded. EBITDA losses for the rest of the CLEC group, on average, cont'd to narrow.
- Following 2Q earnings reports, we have revised ests. as follows: Electric Lightwave — Lowered cap exp est. by $50M or 19% from $270M to $220M; ICG — Lowered 1999 revs. by $82M or 9% from $869M to $787M & EBITDA by $21M or 18% from $114M to $93M following the expected run off of Zycom revs. & lower than est. switc hed services revs., no change to 1998 ests.; Teligent - Increased 1998 est. EBITDA loss by $37M or 33% from $113M to $150M due to accelerated city rollout plan; & USN — Lowered 1998 est. rev. by $35M or 15% from $238M to $203M & widened our EBITDA loss est. by $2.6M. For 1999, we lowered our rev. est. by $69M or 15% from $449M to $380M & more than doubled our EBITDA loss est. from $48M to $108M due to costs resulting from a shift from pure resale of the RBOC to a facilities-based network strategy and restructuring that should reduce salesforce headcount.
- After outperforming the market by 31 percentage points through mid-March, CLEC shares have since underperformed the market by 67 points, netting to 32 points underperformance year-to-date. We believe that funding concerns have led to overselling & look for industry consolidation and improving EBITDA improvement to re-ignite interest in CLECs. We highlight the following stocks: Intermedia with PMV of $52; e.spire with PMV of $31; RCN with PMV of $39; and, Teligent with PMV of $37.

Merrill Lynch & Co.
Global Securities Research & Economics Group
Global Fundamental Equity Research Department

Merrill Lynch & Company Global Telecom Services Team

Daniel P. Reingold, CFA
Global Telecom Research
Coordinator and Sr. US Wireline Analyst
(1) 212 449-5631

U.S. Wireline:
Mark Kastan, CFA
(1) 212 449-3241

Megan Kulick, CFA
(1) 212 449-0847

John R. Sini, Jr.
(1) 212 449-1050

Shannon S. Cross
(1) 212 449-4341

Ehud Gelblum, Ph.D.
(1) 212 449-4471

U.S. Wireless:
Linda J. Mutschler
(1) 414 273-7201

Paul Wuh
(1) 212 449-0184

Mark Kinarney
(1) 212 449-8205

Asia-Pacific:
Craig Irvine
(65) 330-7212

Orawan Karoonkornsakul *(Thailand)*
(662) 664-1500 x 109

Kislay Kanth *(India)*
(1-22) 288-1198

Paul Kim *(Korea)*
(822) 3707-0400

Raymond Ricafort *(Philippines)*
(63-2) 814-5727

Global Satellite:
Tom Watts
(1) 212 449-1214

Cara Eio
(852) 2536-3961

Armand Musey
(1) 212 449-0941

Australia :
Patrick Russel
(613) 9659-2740

New Zealand
Michelle Elsig
(649) 356-2986

Japan:
Kiyohisa Ota
(813) 3213-6252

Richard Kaye
(813) 3213-8214

Europe:
Chris McFadden, Ph.D
(44-171) 867-4409

Simon Carrington, AIIMR
(44-171) 772-1556

Victoria Granger
(44-171) 772-1368

Jan Sudol *(Emerging Europe)*
(44-171) 772-1414

United Kingdom
Mark Lambert
(44-171) 892-4843

Jo Oliver
(44-171) 772-1069

Katie Still
(44-171) 772-1841

Central & South America:
Raymond E. Liguori
(1) 212 449-2667

Dana Cimilluca
(1) 212 449-7067

Canada:
Glen Campbell
(416) 586-6094

Jason Gould
(416) 586-6030

CONTENTS

1. CLEC Industry 2Q98 Summary

Strong Data and Dedicated Revenues Led Solid Corporate Revenue Growth

2Q results for the CLEC (competitive local exchange carrier) sector continued to show strong revenue growth for the period, up 60% year over year and 36% sequentially, led by strong data and dedicated services revenues. We estimate that the CLECs' (including local efforts by LD companies) revenue share of the local telephone market stood at 4.1% at the end of June, an approximate 60 basis point increase over the 3.5% share held at the end of 1Q. As the 4.1% market share for the period was in line with our prior forecasts, we maintain our estimate that the CLEC share will increase to 5.4% by 4Q98.

2Q CLEC Annualized Share Gain Was 2.1%, Up 20 Basis Points Over 1Q

In terms of annualized share gain, we estimate that during 2Q CLECs (including local efforts by LD companies) captured 0.53% of the current $102 billion local market or an annualized share gain of 2.1%. This was an increase of 20 basis points over 1Q's annualized share gain of 1.9%. We continue to expect the CLECs annualized share gain to increase to 2.6% of the $105 billion local market by 4Q98.

As We Had Predicted, Sequential Access Line Growth Began Accelerating During 2Q

During 2Q, CLECs as a group added 640,000 net local lines, a sequential increase of 12% and in line with our expectations. As we forecasted, 2Q's 12% sequential access line growth marked an acceleration vs. the 11% sequential growth rate reported for 1Q98 though still below the 67% and 24% seen in 3Q and 4Q 1998. We believe that benefits are beginning to accrue from recent investments by the CLECs in automated provisioning systems and electronic interfaces with the ILECs (incumbent local exchange carriers). We expect that these investments will allow the sequential line growth trend to modestly accelerate to 13% and 14% for 3Q and 4Q, respectively.

EBITDA Improvement Continued During 2Q, Highlighted By Intermedia Reaching The Key Goal Of Positive EBITDA

2Q CLEC EBITDA performance was highlighted by Intermedia's breakout to positive EBTIDA. The majority of the other public CLECs continued to show improvement in reported EBITDA losses during the quarter with the exception of RCN and Electric Lightwave. We attribute the widening in EBITDA losses for these two companies to RCN's start up expenses and Electric Lightwave's significant spending on billing and provisioning platforms in preparation for future growth. We continue to expect improving EBITDA from the CLEC group as a whole and maintain our estimate that ICG will join Intermedia by reporting positive EBITDA for 4Q98.

Just as in the case of Electric Lightwave, the CLECs, as a group, are continuing to spend heavily on back office systems (i.e., billing, line provisioning and customer service) and expansion of customer support personnel. We continue to believe that these investments are necessary preparation for future revenue growth. We anticipate that the impact of these investments will diminish greatly as fixed SG&A and operating costs are leveraged against rapidly increasing revenues.

CLEC Stocks Have Outperformed The S&P 500 By 32% Through Mid-March But Have Weakened Significantly & Now Trail The S&P 500 By 67% Year-To-Date

CLEC stocks have underperformed the market year-to-date, as a strong outperformance of 32% through mid-March has since been significantly offset by 67% underperformance. We believe that the recent spate of weak relative stock price performance is as a result of the following factors:

- A period of stock price correction following an especially torrid run from December 1997 through mid-March. As an example, on December 5, 1997 we named Intermedia Communications our US focus stock for 1998. Following that, the stock outperformed the S&P 500 by 60.4% through the mid-March peak in the CLEC group;
- The lessening of euphoria concerning strong outlooks for data and internet traffic growth that culminated at our global telecom CEO conference in mid-March;

4. Line Mix

Line Mix Is Crucial To Gross Margins

Table 9 and Chart 10 below detail our estimates of line mix for the CLECs' access lines in service at 2Q. We estimate that the average mix of lines in service during 2Q was 36% via on-net, 28% via unbundled network elements (UNE), and 38% via total service resale (TSR), virtually unchanged from 1Q. We believe CLEC line mix will begin to trend more towards on-net and UNE transmission during late 1998 as CLEC local network reach expands due to continued facilities buildout.

As shown in Table 9 below, according to our estimates, CLECs with a high percentage of on-net traffic (and therefore the opportunity for higher margins) include:

- Electric Lightwave with 83% via on-net;
- Teleport with 80% via on-net; and,
- WorldCom's local divisions MFS and Brooks with 75% and 60% via on-net, respectively.

CLECs which rely predominately on resold facilities according to our estimates include:

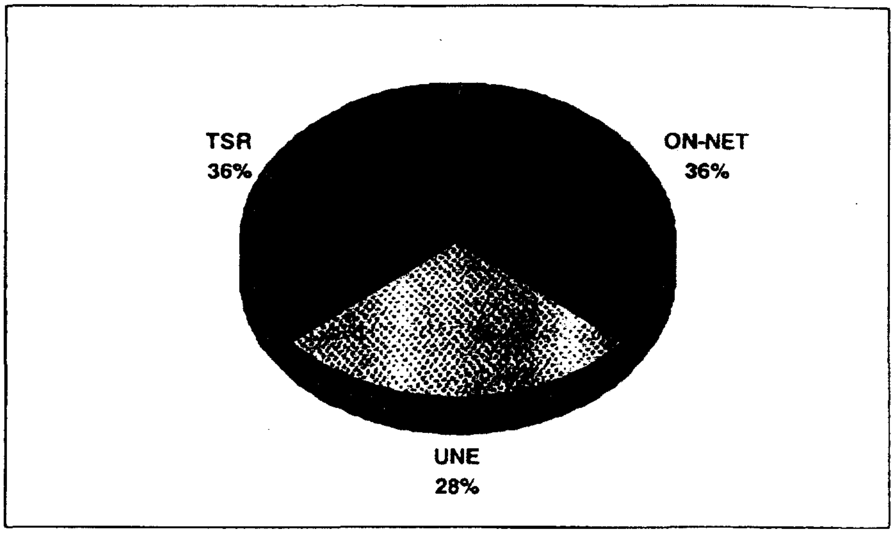
- USN with 100% via TSR;
- McLeod with 90% via TSR; and,
- RCN with 85% via TSR due to the company's strategy of reselling access lines in advance of network construction.

Table 9: Estimated 2Q98 CLEC Line Mix

	On-net	UNE	TSR	Total
e.spire	14%	21%	65%	100%
Brooks Fiber	60%	35%	5%	100%
Electric Lightwave	83%	15%	2%	100%
Focal	0%	90%	10%	100%
Frontier	0%	2%	98%	100%
GST	10%	50%	40%	100%
Hyperion	0%	86%	14%	100%
ICG	43%	19%	38%	100%
Intermedia	40%	20%	40%	100%
McLeod	0%	10%	90%	100%
NEXTLINK	20%	75%	5%	100%
RCN	15%	0%	85%	100%
Teleport	80%	20%	0%	100%
US LEC	0%	100%	0%	100%
USN	0%	0%	100%	100%
WinStar	15%	5%	80%	100%
WorldCom (MFS)	75%	25%	0%	100%
AT&T (Local)	20%	15%	65%	100%
MCIMetro	50%	50%	0%	100%
Sprint (Local)	0%	30%	70%	100%
Weighted Average	**36%**	**28%**	**36%**	**100%**

Source: Merrill Lynch estimates

Chart 10: 2Q98 Estimated CLEC Industry Weighted Average Line Mix



Source: Merrill Lynch estimates

Line mix is a critical variable in analyzing the true fundamental performance of a CLEC because each local access method provides the ability to attain a different EBITDA margin. In general, CLECs provide local network connectivity to customers through one of the following three methods (for a graphical depiction, please see charts 11A-C below). Our derivation of potential EBITDA margins is shown in Table 10:

- **On-net**: These access lines are provided 100% over the CLEC's own facilities including last mile either through wireline or wireless transmission; with a potential 40% EBITDA margin, over time, for local switched revenues;
- **Unbundled network elements (UNE)**: These access lines are provided over a combination of CLEC owned and leased facilities (especially last mile loops) from the ILEC with a potential 25% EBITDA margin, over time, for local switched revenues; and,
- **Total service resale (TSR)**: These access lines are provided 100% over leased ILEC facilities; with a potential 5% EBITDA margin, over time, for local switched revenues.

■ Share of US Local Revenue & Access Lines

We estimate that the CLECs' (including local efforts by LD companies) market share stood at 4.1% of the US local market at the end of 2Q, an approximate 60 basis point increase over the 3.5% share garnered by 1Q. As shown in Table 13 below, we estimate that the CLEC share will increase to 5.4% by 4Q98.

As of 2Q, the local competitors in aggregate had approximately 3.5 million local lines in service, equating to 2.0% of the 174 million local access lines in service in the US market. We estimate that local competitors' access lines in service will grow by over 75% or 1.5 million access lines in the next 2 quarters, reaching 5.1 million local access lines in service by the end of 4Q98, equating to 2.9% of US local access lines. Table 13 below details the actual net access lines in service at quarter-end as well as our quarterly line forecast for 1998.

Table 13: Local Competitors' Share Of Local Access Lines & Revenues

	Company	4Q97A	1Q98A	2Q98A	3Q98E	4Q98E
A	e.spire	35,105	57,500	85,633	115,633	150,633
B	Brooks Fiber	105,000	145,000	185,000	235,000	300,000
C	Electric Lightwave	34,322	41,270	54,470	66,470	81,470
D	Focal	6,300	14,528	24,528	37,028	52,028
E	Frontier	100,000	116,000	134,000	155,000	179,500
F	GST	28,853	44,846	71,846	106,846	151,846
G	Hyperion	25,000	36,000	50,000	69,000	93,000
H	ICG*	93,000	138,100	189,458	244,000	303,000
I	Intermedia*	81,349	108,987	150,500	196,400	245,400
J	McLeod*	193,000	223,200	255,200	289,200	325,200
K	NEXTLINK*	50,131	71,023	101,076	136,076	176,076
L	RCN	24,900	40,000	60,480	85,480	115,480
M	Teleport	282,700	325,874	371,940	420,000	480,000
N	US LEC	49,229	75,536	103,536	133,536	165,536
O	USN	172,000	226,000	276,000	326,000	371,000
P	WinStar*	65,600	96,800	135,056	174,852	216,063
Q	WorldCom (MFS)	309,000	399,000	444,000	499,000	549,000
R	Total CLEC	1,655,489	2,159,664	2,692,723	3,289,521	3,955,232
S	AT&T (Local)**	295,573	322,917	369,167	424,167	494,167
T	MCIMetro**	295,573	322,917	369,167	424,167	494,167
U	Sprint (Local)**	73,893	80,729	92,729	107,729	125,229
V sum(s:u)	Total LD	665,039	726,563	831,063	956,063	1,113,563
w (r+v)	**Total Lines In Service**	**2,320,528**	**2,886,227**	**3,523,786**	**4,245,583**	**5,068,795**
	Sequential Growth		**565,698**	**637,559**	**721,798**	**823,212**
X our est	**Estimated 1998 US Access Lines**	**170,000,000**	**172,000,000**	**174,000,000**	**176,000,000**	**177,000,000**
Y (x/w)	**Local Competitors' Share**	**1.4%**	**1.7%**	**2.0%**	**2.4%**	**2.9%**
	Local Competitor Switched Revenue Share of US Local Market					
Z our est.	Monthly Local Switched Revenue Per Line	$63.68	$64.00	$64.32	$64.64	$64.96
AA (BB*y)	Estimated Switched Monthly Revenue ($ Millions)	147.8	184.7	226.6	274.4	329.3
BB (our est.)	Estimated Dedicated Monthly Revenue ($Millions)	100.9	111.9	122.6	132.1	142.6
CC (AA+BB)	Total Monthly Revenue ($Millions)	248.7	296.6	349.2	406.5	471.9
DD (CC*12)	Total Annualized Revenue ($Millions)	2,984.5	3,559.1	4,190.4	4,878.6	5,663.0
EE (out est.)	Estimated US Local Market	100,000	101,000	102,000	103,000	105,000
FF (DD/EE)	**Share of Local Market at Quarter End**	**3.0%**	**3.5%**	**4.1%**	**4.7%**	**5.4%**
II	**Incremental Share of Local Market Gained During Quarter**		**0.54%**	**0.58%**	**0.63%**	**0.66%**

*Excludes acquired lines 1Q98:111,600 from Intermedia's acquisition of Shared Tech, 1,811 from NEXTLINK's acquisition of Start Technologies, 24,000 from WinStar's acquisition of Goodnet & Pacnet, 4Q97 8,000 from McLeod's acquisition of Consolidated & 48,000 from ICG's acquisition of CBG.; and, 1Q98: 18,400 from Intermedia's acquisition of National Tel WinStar lines net of long distance only lines (approximately 20% for 2Q98).

** LD access line count based on1997 switched revenues of $100M AT&T, $100M MCI, $25M Sprint and $64 monthly revenue per line; and 1998 switched revenues $300M AT&T, $300M MCI, $75M Sprint and $65 monthly revenue per line

Source: Merrill Lynch estimates and company reports

Certificate of Service

I, Bridget J. Szymanski, hereby certify that on this twenty-sixth day of October, 1998, copies of the foregoing Comments of the Competition Policy Institute were served by hand or by first-class, United States mail, postage prepaid, upon each of the following:

Bridget J. Szymanski

Bridget J. Szymanski

Magalie Roman Salas, Secretary
Federal Communications Commission
Room 222
1919 M St., NW
Washington, DC 20554

ITS
1231 20th St., NW
Washington, DC 20037

Brian Moir
2000 L St., NW Suite 512
Washington, DC 20036-4907

James Blaszak
2100 L St., NW Suite 900
Washington, DC 20036

Alan Buzacott
MCI Telecommunications
1801 Pennsylvania Ave.,NW
Washington, DC 20006

Catherine R Sloan
Richard Fruchterman, III
Richard Whitt
David Porter
1120 Connecticut Ave., NW Suite 400
Washington, DC

Robert Aamoth
Kelly Drye & Warren
1200 19th St., NW Suite 500
Washington, DC 20036

Competitive Pricing Division Chief
Common Carrier Bureau
Federal Communications Commission
1919 M St., NW
Washington, DC 20554

Mark Cooper
Consumer Federation of America
1424 16th St., NW , Suite 604
Washington, DC 20036

Cathy Hotka
National Retail Federation
327 7th St., NW
Washington, DC 20004

Leon Kestenbaum
Jay Keithley
H Richard Juhnke
1850 M St., NW 11th Floor
Washington, DC 20036

Joseph DiBella
1320 North Court House Rd.
Arlington, VA 22201

Genevieve Morelli
CompTel
1900 M St., NW Suite 800
Washington, DC 20036

James Smith
Excel Telecommunications
3000 K St., NW Suite 300
Washington, DC 20007

James Troup
Arter & Haden
1801 K St., NW Suite 400K
Washington, DC 20036-1301

Mary McDermott
USTA
1401 H St., NW Suite 600
Washington, DC 20005

Rocky Unruh
Morganstein & Jubelirer
One Market Spear Street Tower
32nd Floor
San Francisco, CA 94105

Mark Rosenblum
AT&T Corporation
Room 324511
295 North Maple Ave
Basking Ridge, NJ 07920

David Porter
1120 Connecticut Ave., NW Suite 400
Washington, DC 20036

Robert McKenna
1020 19th St., NW Suite 700
Washington, DC 20036

Wayne Black
Keller & Heckman
1001 G St., NW Suite 500 West
Washington, DC 20001

Anne Bingaman
LCI
8180 Greensboro Dr. Suite 800
McLean, VA 22102

Peter Keisler
Sidley & Austin
1722 Eye St., NW
Washington, DC 20006

M. Robert Sutherland
1155 Peachtree St., NE Suite 1700
Atlanta, GA 30306-3610

Michael Pabian
Room 4H82
2000 West Ameritech Center Dr.
Hoffman Estates, IL 60196-1025

Charles Hunter
Hunter Communications Law Group
1620 Eye St., NW Suite 701
Washington, DC 20006